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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

CHARLES AGEE ATKINS and WILLIAM S. HACK,

Petitioners,

—v.—

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

1. Whether a challenge to a criminal statute for failing to meet an objective test of fair notice is precluded by evidence that the defendant held a subjective belief that his activity was illegal.

2. Whether, for purposes of criminal tax law, legally enforceable transactions are devoid of "economic substance" if they are solely tax-motivated and have no market risk.

3. Whether a criminal prosecution based on the unsettled judicial doctrine of economic substance violates the constitutional principles of lenity and fair notice.

PARTIES TO THE PROCEEDING

Petitioners—Charles Atkins and William S. Hack—were defendants in the criminal case below, *United States* v. *Atkins*, 661 F. Supp. 491 (S.D.N.Y. 1987) (App., *infra*, 1b-11b).

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Grand & Ostrow, on behalf of petitioners, Charles Atkins and William S. Hack, petitions for a writ of certiorari to review the decision of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (App., *infra*, 1a-11a) is published at *United States* v. *Atkins*, 869 F.2d 135 (2d Cir. 1989). The decision of the District Court (App., *infra*, 1b-11b) is reported at 661 F.Supp. 491 (S.D.N.Y. 1987).

JURISDICTION

The judgment of the Court of Appeals was entered on February 23, 1989 (App., *infra*, 1d-2d). The petition for rehearing was denied on April 10, 1989 (App., *infra*, 1c). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT

1. The facts pertinent to this petition are set forth in the panel opinion and the opinion of the District Court. (App., *infra*, 1a-11b). The essential details may be distilled as follows. The defendant Atkins was a founder and general partner of an investment banking partnership, The Securities Groups ("TSGS"). The defendant Hack organized numerous partnerships which traded U.S. government securities with TSGS. As described by the panel, TSGS, amongst other activity, bought and sold U.S. government securities with securities dealers such as First Boston Corporation and Donaldson, Lufkin and Jenrette and with partnerships, such as those organized by the defendant Hack. The evidence showed that TSGS periodically bought and sold these securities to generate tax losses for its partners and not to realize economic gains. *Id.* at 3a. TSGS generated these tax losses by two means: prearranged tax straddles and repurchase agreements. *Id.* at 4a.

During the period of the alleged conspiracy (1978-83), tax straddle trades were commonly used by many taxpayers to defer their taxable income. *Id.* at 5a. A taxpayer "puts on" a tax straddle by simultaneously entering into roughly equivalent and opposing purchase and sale positions in similar securities. *Id.* As prices or interest rates change, one position loses money and the other position has an equivalent gain. *Id.* At the end of a tax year, the taxpayer may close out the unrealized loss position of the straddle to recognize a tax loss and, in the following tax year, may close out the opposing position to recognize an equivalent gain—thus deferring tax on income in the amount of such loss/gain for one year. *Id.* Typically, this simple tax straddle is not risk free, for fluctuations in prices and interest rates may

affect each part of the straddle differently. *Id.* at 5a-6a. However, straddles usually have less risk than non-straddle transactions.

TSGS transactions actually took place at market prices and market interest rates, and gains and losses were realized on the trades. However, some employees of TSGS entered into agreements with trading counterparts to eliminate the residual market risk of its U.S. government securities transactions. Under these agreements, after TSGS closed a losing position at the end of one tax year, TSGS "put the straddle back on" and hedged the gain position of the original straddle. *Id.* at 6a. "This would insure that, no matter which way the market moved, the deferred gain on the original straddle would not be affected" and that any expectation of profit from these transactions was eliminated. *Id.* at 6a.

TSGS also used repurchase ("repo") agreements to defer taxable gains. In these financing agreements, TSGS borrowed money secured by government securities by agreeing to sell securities and repurchase them later. *Id.* at 7a-8a. By engaging in these financing transactions over multiple tax years, TSGS achieved interest deductions in one tax year and equivalent gains in the following tax year—while eliminating market risk by financing these transactions to maturity. *Id.* at 8a.

The jury heard evidence that the defendants and/or their co-conspirators falsified and back-dated documents and disguised payments as trading losses. *Id.* at 8a-9a. However, the District Court refused to charge the jury that it was to find deductions fraudulent only if they were based on transactions that were unreal or fictitious; rather, the District Court instructed the jurors to find deductions fraudulent if they were based on transactions devoid of profit motive and market risk. Thus, no issue of fact was ever submitted to the jury concerning the Government's proof of document falsification, back-dating and the like.

Defendants Charles A. Atkins and William S. Hack were indicted and convicted on several counts of violating §§ 7206(1) and (2) of the Internal Revenue Code (the "Code") and on one

count of conspiring to violate §§ 7206(1) and (2) and to defraud the Internal Revenue Service, 18 U.S.C. § 371. The theory of the prosecution was that deductions created by TSGS' trading were not valid because they were based on transactions which lacked "economic substance." In indicting the defendants, the Government applied to a criminal tax prosecution a judge-made civil tax doctrine that permits the Commissioner of Internal Revenue to invalidate deductions claimed from legally enforceable transactions on the ground that, for tax purposes, the transactions were without "economic substance." Thus, the definition of economic substance, as the District Court instructed the jury, was at the "heart of the case."

2. The District Court instructed the jury that a transaction lacked economic substance if (a) it is not intended "to make or preserve [a] profit or to limit a loss" and (b) it is not subject to market risk, *i.e.*, "changes in market prices cannot have any effect" on it. (App. *infra*, 11a).

In the District Court and on appeal, the defendants argued that the judge-made doctrine of economic substance was sufficiently unclear to provide fair notice of what "economic substance" meant—thus precluding criminal tax prosecutions based on that theory. The defendants further argued that the District Court erred in refusing to charge the jury that economic effects unrelated to market risks were relevant to "economic substance." (*See infra* at 13, discussing these effects).

3. The Court of Appeals, affirming the convictions, held that defendants' fair notice argument was precluded because the prosecution introduced evidence demonstrating a subjective belief by the defendants that their conduct was illegal (*e.g.*, falsification of documents). The Court went on to uphold the District Court's instruction as to the lack of economic substance (*i.e.*, transactions lack economic substance if they are solely tax-motivated and have no market risk).

REASONS FOR GRANTING THE WRIT

This case presents three questions: (a) whether a challenge to a criminal statute on the grounds that it fails to meet an objective test of fair notice is defeated by the introduction of evidence that the defendant held a subjective belief that his activity was illegal, (b) whether, for purposes of the tax law, legally enforceable transactions with non-market (*i.e.*, non-price) economic effects lack economic substance because they are entered into solely for tax purposes and have no market risk, and (c) whether a criminal prosecution based on the unsettled judicial doctrine of economic substance violates the constitutional principles of lenity and fair notice.

As to the first question, the opinion of the Second Circuit—in endorsing a subjective test—contradicts this Court's holding in *United States* v. *Kozminski*, 108 S.Ct. 2751, 2763 (1988) and *United States* v. *Harriss*, 347 U.S. 612, 617 (1954), the Fourth Circuit's holding in *United States* v. *Critzer*, 498 F.2d 1160, 1162-1164 (4th Cir. 1974) and the Fifth Circuit's holding in *United States* v. *Garber*, 607 F.2d 92, 98-99 (5th Cir. 1979). The Second Circuit's position on the second question creates a conflict between the Second Circuit, which has defined economic substance narrowly to exclude tax-motivated transactions without market risk, and the Sixth, Seventh and Ninth Circuits, which hold that transactions have economic substance if they have non-market economic consequences.

1. a. The Second Circuit held in the case below that a subjective test may be used in determining whether a criminal statute fails to provide fair notice of the activity that is unlawful. This holding cannot be squared with a line of Supreme Court decisions in which the Court has set forth an objective test for determining fair notice: "The constitutional requirement of definiteness is violated by a criminal statute that fails to give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden by the statute." *Harriss*, 347 U.S. at 617.

The objective test was recently reaffirmed by the Supreme Court in *United States* v. *Kozminski*, 108 S.Ct. 2751, 2763

(1988). The defendants, in *Kozminski*, were charged with conspiring to subject and subjecting two mentally retarded adults to involuntary servitude. The Court rejected the Government's argument that ambiguity in the state of the law was overcome if the defendants had a specific intent to violate the law and engaged in clearly wrongful conduct.

> . . . [I]n light of the Government's failure to give any objective content to its construction of the phrase "involuntary servitude," [a] specific intent requirement amounts to little more than an assurance that the defendant sought to do "an unknowable something."

Kozminski, 108 S.Ct. at 2763, *quoting Screws* v. *United States*, 325 U.S. 91, 105. *See James* v. *United States*, 366 U.S. 213, 221-22 (1961); *McBoyle* v. *United States*, 283 U.S. 25, 27 (1931) (Holmes, J.) (due process requires that "fair warning should be given . . . in language that the common world will understand."). It is to be concluded from this that the constitutional requirement of fair notice will prohibit a prosecution even though there is evidence that a defendant engaged in conduct which he believed to be wrongful.

b. In upholding the use of a subjective test of fair notice, the Second Circuit has also placed itself in direct conflict with the Fourth and Fifth Circuits. In *United States* v. *Critzer*, 498 F.2d 1160 (4th Cir. 1974), a case which involved the under-reporting of income derived from land held in trust by an Indian tribe, the Fourth Circuit reversed the defendant's conviction despite clear evidence that the false reporting was intentional.

> The obligation to pay is so problematical that defendant's actual intent is irrelevant. Even if she had consulted the law and sought to guide herself accordingly, she could have had no certainty as to what the law required.

Id. at 1162. The Court went on to state that it is "settled that when the law is vague or highly debatable, a defendant—actually or imputedly—lacks the requisite intent to violate it." *Id.*

The Fourth Circuit's holding in *Critzer* was followed by the Fifth Circuit in *United States* v. *Garber*, 607 F.2d 92 (5th Cir. 1979). The defendant in that case was convicted of income tax evasion for failing to report the proceeds received from the sale of her blood plasma. The defendant attempted to introduce expert testimony regarding the confusion in the applicable tax law. The District Court refused to permit the testimony, holding that the only relevant issue on fair notice was the defendant's subjective view of the statute.

The Fifth Circuit, in reversing the conviction, ruled that "the unresolved nature of the law is relevant to show that defendant may not have been aware of a tax liability or may have simply made an error in judgment." *Garber*, 607 F.2d at 98. The Court went on to hold that "the relevance of a dispute in the law does not depend on whether the defendant actually knew of the conflict." *Id.*

The uncertainty of the law affects criminal liability in two ways: it negates the element of willfulness and second, it violates the constitutional principle of fair notice. As to both, the circuit courts have applied an objective test in determining the uncertainty of the statute. *James* v. *United States*, 366 U.S. 213, 221-222 (1961); *United States* v. *Mallas*, 762 F.2d 361, 363 (4th Cir. 1985); *United States* v. *Garber*, 607 F.2d at 98; *United States* v. *Critzer*, 498 F.2d at 1162; Note, "Criminal Liability for Willful Evasion of an Uncertain Tax," 81 *Colum. L. Rev.* 1348, 1359 (1981) ("Although the *James* and *Critzer* opinions were written in terms of willfulness, the Justices and judges seemed to be applying a traditional vagueness analysis.").

Moreover, when, as in the present case, the law is challenged as violative of fair notice (*i.e.*, due process), the logic of an objective test is particularly compelling. "To protect the public from arbitrary and unfair enforcement, the government is required to use sufficient clarity in defining crimes. This policy is strong enough to mandate dismissal of a criminal prosecution if the law is vague, *regardless of the defendant's mental state.*" Note, "Criminal Liability for Willful Evasion of an Uncertain Tax," 81 *Colum. L. Rev.* at 1362-1363 (emphasis added).

c. That the law regarding tax straddles was unclear at the time defendants engaged in creating such straddles is demonstrated by the Tax Court's decision in *Smith* v. *Commissioner*, 78 T.C. 350, 385-394 (1982), *aff'd without op.*, 820 F.2d 1220 (4th Cir. 1987). The Tax Court in *Smith* set aside Revenue Ruling 77-185, which disallowed deductions taken on straddles that were "entered into for purposes of taxable gain and with minimal economic risk." Despite the fact that the trades in *Smith* lacked a reasonable expectation of profit and were entered into solely for tax objectives, the Tax Court concluded that the transactions had economic substance because Congress had accepted the economic reality of straddle trading. *Id.* at 387-390.

d. The petitioners do not claim that fair notice requires that defendants have prior notice of the specific statutes under which their conduct may be prosecuted. Nor do the petitioners claim that they may not be prosecuted unless there is exact factual precedent for the prosecution. The petitioners do claim—and the Government cannot deny after *Kozminski*—that fair notice requires that a person of reasonable intelligence, if he had read the statute in question, would have understood that his conduct was covered by that statute. This standard has been rejected in this case by the Second Circuit in favor of a subjective standard.

e. The decision before this Court is of unusual significance. In any criminal case there will be at least some evidence to demonstrate consciousness of wrongdoing. This evidence, however minimal, will now truncate any inquiry into the objective uncertainty of a statute. The Second Circuit's opinion will thus have the effect of eliminating virtually all challenges to criminal statutes based on the doctrines of unfair notice, void for vagueness, or absence of willfulness owing to statutory uncertainty.

2. a. The Second Circuit identified two categories of "sham" transactions under the tax laws: transactions that are fictitious (*i.e.*, unreal) and transactions that actually occurred but are devoid of "economic substance." The Second Circuit held that as to the second category (a category upon which the

jury verdict must have been based in light of the District Court's instructions), a transaction lacks economic substance if (a) it is not intended to make or preserve a profit or limit a loss and (b) has no market risk.

This definition conflicts with that adopted by the Sixth, Ninth and Seventh Circuits, which hold that a transaction lacks economic substance only if it has no "economic effect" other than those generated by the tax loss. *Rose* v. *Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989) ("The proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses."); *Yosha* v. *Commissioner*, 861 F.2d 494, 499 (7th Cir. 1988) (" 'no nontax motive or consequences,' [is] the test under the judge-made doctrine of substance over form, applicable to all deductions."); *Collins* v. *Commissioner*, 857 F.2d 1383, 1385 (9th Cir. 1988) ("the court should determine whether the transaction 'had any practical economic effects other than the creation of income tax losses.' " *quoting Sochin* v. *Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988)).

In summarizing the law on this subject, Boris Bittker states that "a transaction is apparently a sham in substance if, in substance, it effects no significant change in the parties' economic position." B. Bittker & L. Loakken, 1 *Federal Taxation of Income, Estates and Gifts* ¶ 4.3.3 at 4-39 (2d ed. 1989).

Since market risk is simply one of many possible economic effects or changes in the economic position of the parties, the Second Circuit's definition is qualitatively narrower than the effects test employed by the Sixth, Seventh and Ninth Circuits. Moreover, this difference is critical to the present case because the transactions under consideration, though having no market risk, did have economic consequences independent of those generated by the tax deductions. For example, the straddles created by the petitioners resulted in non-price (*i.e.*, non-market) financial effects in the form of (a) credit risks and (b) financial limitations on the ability of the parties to engage in other investment opportunities. *See infra* at 13. Defendants requested an

instruction allowing the jury to consider these other factors; the District Court expressly declined to give the instruction.

As the law now stands, the Second Circuit's definition of economic substance creates a split between the Second Circuit's market risk test and the Sixth, Ninth and Seventh Circuits' economic effects test.

b. This Court should be aware that prominent commentators on the law of taxation have attacked the entire doctrine of economic substance as a judicial usurpation of the authority of Congress, resulting in holdings that contradict the language and intent of the tax statutes. *E.g.*, J. Isenbergh, "Musings on Form and Substance in Taxation," 49 *U. Chi. L. Rev.* 859, 863-866, 879-883 (1982). This criticism demonstrates the need for a comprehensive review of the economic substance doctrine—a review that is of particular importance in light of the fact that the Government is now using the economic substance doctrine as a basis for criminal prosecutions.

c. The test adopted by the Second Circuit has also been criticized to the extent that it defines economic substance in terms of profit motive or potential. A. Warren Jr., "The Requirement of Economic Profit in Tax Motivated Transactions," 59 *Taxes* 985, 989-990 (1981). One of the reasons for this criticism is that such a test, if applied, would eliminate "whole classes of transactions" that are "uneconomical absent the effect of particular tax allowances." J. Isenbergh, 49 *U. Chi. L. Rev.* at 876. According to this analysis, the Second Circuit's condemnation of all tax-motivated transactions lacking market risk will threaten those transactions that are tax-exempt or deductible, that offer no reasonable prospect of profit, and that are intended to eliminate market risk.

Only a few illustrations need be noted. Tax-free pension funds hold cash reserves; individuals borrow funds to purchase real estate to gain interest deductions even though their mortgage interest rate exceeds the market rate of return on their investment; investors sell stock or securities following a market decline to deduct their losses. *See id.* ("[O]ne of the principal advantages of home ownership is the tax benefit of deductible

mortgage interest coupled with the exclusion of the imputed rental income from taxation. In many cases the purchase of a house with borrowed money is demonstrably uneconomical without this tax benefit. . . .").

d. The definition of economic substance adopted by the District Court and affirmed by the Second Circuit had the effect of severely restricting the arguments that petitioners were permitted to advance at trial. Those Circuits that have broadly defined economic substance and the Supreme Court, to the extent it has discussed the concept of sham, have held the following evidence to be relevant as indicia of economic substance: the agreements were bargained for at arm's-length, *United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725, 736-737 (1977), *Yosha* v. *Commissioner*, 861 F.2d at 497-498; credit or other non-market risks resulted from the transactions, *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 577 (1978); and the transactions were enforceable under state law, *Consumer Life Ins. Co.*, 430 U.S. at 737, *Wiggin* v. *Commissioner*, 46 F.2d 743, 746 (1st Cir. 1931) ("The test of the validity of these contracts is not whether the motive therefor . . . may not have been to reduce Wiggin's income taxes; the test is whether the transaction was real, the contract valid.").

In *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), the Court held that assumption of large liabilities can create economic reality in a transaction:

> The effect of this liability on Lyon is not just the abstract possibility that something will go wrong and that Worthen will not be able to make its payments. Lyon has disclosed this liability on its balance sheet for all the world to see. Its financial position was affected substantially by the presence of this long-term debt, despite the offsetting presence of the building as an asset. To the extent that Lyon has used its capital in this transaction, it is less able to obtain financing for other business needs. *Id.* at 577.

The factors described above, as drawn from decisions of the Circuit Courts and Supreme Court, are reflected in the opinions of the Tax Court, which has worked to develop the form-

versus-substance doctrine as "a more objective and useful tool in tax shelter cases." B. Bittker & L. Loakken, 1 *Federal Taxation of Income, Estates and Gifts* ¶ 4.3.3 at 4-39 (2d ed. 1989). The Tax Court has expressly acknowledged the following as relevant to the question of economic substance in tax straddles: the agreements were bargained for at arm's-length, *Falsetti* v. *Commissioner*, 85 T.C. 332, 348 (1985); the transactions were enforceable under state law, *Freytag* v. *Commissioner*, 89 T.C. No. 60, [1987 Transfer Binder] Tax Ct. Rep. (CCH) Dec. No. 44,287 (Oct. 21, 1987) at 3762; margin payments were made, *Freytag* at 3773, *Glass* v. *Commissioner*, 87 T.C. 1087, 1161 (1986), *aff'd*, *Herrington* v. *Commissioner*, 854 F.2d 755 (1988); fees were paid, *Glass* at 1161; and trading was conducted at market prices, *Glass* at 1160.

In his treatise on federal income taxation, Boris Bittker, perhaps the leading authority on federal income taxation, sets forth the following criteria of economic substance:

> "Key indicators of presence or a lack of economic substance include presence or absence of arm's-length price negotiations, the relationship between the sales price and fair market value, the structure of financing of the transaction, whether there was a shifting of the benefits and burdens of ownership, and the degree of adherence to contractual terms."

B. Bittker & L. Loakken, 1 *Federal Taxation of Income, Estates and Gifts* ¶ 4.3.3 at 4-40 (2d ed. 1989), *quoting Rose* v. *Commissioner*, 88 T.C. 386, 410-411 (1987), *aff'd*, 868 F.2d 851 (1989).

Because the District Court defined economic substance to the jury as market risk and non-tax motive and because the additional factors identified by Professor Bittker and the Circuit Courts were never submitted to the jury, the jury was prevented from considering these factors. The instructions to the jury were, therefore, incomplete according to the legal test recognized in the Sixth, Seventh, and Ninth Circuits.

The petitioners put forward evidence which made each of these facts critical to the petitioners' defense: the petitioners showed that they entered into agreements following arm's-length bargaining with brokers and market-makers, that these agreements created non-market risks, that trading practices followed standard industry practices in the market for government securities, and that petitioners or their employees monitored market prices to keep track of the size of the unrealized gain.

As to non-price economic effects, the evidence at trial showed that the agreements creating the tax straddle transactions had a substantial economic impact on TSGS. These agreements created a substantial credit risk for TSGS. Not only was there a substantial risk if another dealer was unable or unwilling to perform its end of the agreement, the transactions entered into pursuant to the oral agreements also affected the economic position presented on TSGS financial statements. The transactions, as a result, prevented TSGS from engaging in other investment opportunities. The large gross positions entered into by TSGS also caused the Federal Reserve Bank to limit TSGS's trading activities. Further, because of the substantial risks associated with these transactions, TSGS made and received significant margin payments. In not allowing the evidence of non-market risks to go to the jury, the decisions of the District Court and Second Circuit contradict this Court's holding in *Frank Lyon. Supra* at 11.

Although profit motive and market risk are clearly relevant in determining the economic substance of a tax straddle, these two factors, standing alone, are not dispositive of the economic substance of such transactions. Instead, they are only two of a number of factors which were in dispute in this case and which the jury should have been permitted to consider—and have been considered by other circuits and the Supreme Court—before a finding of fact could be made that a transaction lacked economic substance.

e. The above discussion of economic substance has substantial theoretical and practical ramifications within the law of taxation. The judge-made doctrine of economic substance is so

pervasively applied as to "resemble a preamble to the Code." B. Bittker, 1 *Federal Taxation of Income, Estates and Gifts* ¶ 4.3.1 at 4-26. Consequently, every taxable transaction is subject to review under the test of economic substance. The task before this Court—the task of settling the conflict over the definition of economic substance—is thus of wide ranging importance in the development of the law of taxation.

3. The third issue raised by this case is whether a criminal prosecution based on the unsettled judicial doctrine of economic substance violates the constitutional principles of lenity and fair notice. In *Kozminski*, 108 S.Ct. at 2764, the Court held that the rule of lenity was violated when "judges . . . develop the standards for imposing criminal punishment on a case-by-case basis." The underlying purpose of the rule of lenity, the Court stated, is "to promote fair notice to those subject to the criminal laws, to minimize the risk of selective or arbitrary enforcement, and to maintain the proper balance between Congress, prosecutors, and courts." *Id.*

Applying common law methods of decisionmaking to the inherently legislative task of defining criminal behavior is also inconsistent with the constitutional system of separation of powers. *See Kolender* v. *Lawson*, 461 U.S. 352, 358 (1983). Absent the express consent of Congress, prosecutions based on the unsettled law of economic substance would impose on the courts the duty to define the substantive elements of a transaction lacking in economic substance in criminal cases and would therefore veer sharply from historic constitutional principles of the role of the legislature. *See United States* v. *Bass*, 404 U.S. 336, 348 (1971); *United States* v. *Hudson & Goodwin*, 11 U.S. 32 (1812).

This case illustrates how *ad hoc* common law methods of defining a criminal offense are inconsistent with the principles of lenity and fair notice. The plain language of § 7206 criminalizes preparation of "false" or "fraudulent" tax returns. The plain meaning of the statute does not explain whether the statute's prohibition extends to transactions whose economic substance differs from their genuine or "true" legal form.

The Second Circuit is unable to offer any then-applicable case law, regulations, or statutory authority concerning the validity of deductions from the pre-arranged and riskless tax straddle transactions entered into by the petitioners. As discussed above, the state of the law at the time of the transactions (1978-1983) was uncertain, with the *Smith* court expressly approving such trades. *Supra* at 8. Moreover, the Second Circuit's decision conflicts with Tax Court decisions refusing to apply even civil sanctions to taxpayers claiming deductions from pre-arranged patterns of straddle trading similar to those here because "the law with respect to tax straddles was uncertain." *Ewing* v. *Commissioner*, 91 T.C. 396 (1988), Tax Ct. Rep. (CCH) Dec. 45,018 at 3425; *Brown* v. *Commissioner*, 85 T.C. 968 (1985), Tax Ct. Rep. (CCH) Dec. 42,547 at 3806 (1985), *aff'd, Sochin* v. *Commissioner*, 843 F.2d 351 (9th Cir. 1988). *Accord Kilingworth* v. *Commissioner*, 864 F.2d 1214, 1217 (5th Cir. 1989) ("Before the enactment of Section 108 [in 1984], the circumstances under which a taxpayer could deduct the losses from a commodities future straddle were unclear"). All of the decisions relied upon by the Second Circuit to support the proposition that the economic substance doctrine was "well ensconced" in the law post-date the relevant period--1978-1983. Thus, they cannot be relied upon to defeat the petitioners' claim that the prosecution violates the principles of lenity and fair notice.

Absent a legislative resolution of the judicial differences over the definition of economic substance, the doctrines of lenity and fair notice should preclude all criminal prosecutions based on that concept.

Conclusion

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 256, 257—August Term, 1988

(Argued September 6, 1988 Decided February 23, 1989)

Docket Nos. 88-1116, 88-1123

UNITED STATES OF AMERICA,

Appellee,

—v.—

CHARLES AGEE ATKINS and WILLIAM S. HACK,

Defendants-Appellants.

Before:

VAN GRAAFEILAND, KEARSE, *Circuit Judges*,
and POLLACK, *District Judge*.*

Appeals from judgments of the United States District Court for the Southern District of New York (Weinfeld and Lasker, J.J.), convicting appellants of violating and

* Honorable Milton Pollack, United States District Judge for the Southern District of New York, sitting by designation.

conspiring to violate 26 U.S.C. §§ 7206(1) and (2) and 18 U.S.C. § 371.

Affirmed.

STUART E. ABRAMS, Assistant United States Attorney for the Southern District of New York, New York, New York, (Rudolph W. Giuliani, United States Attorney for the Southern District of New York, Jordan S. Stanzler and Kerri L. Martin, Assistant United States Attorneys for the Southern District of New York, New York, New York, of counsel), *for Appellee.*

MITCHELL ROGOVIN, Washington, D.C., (Peter M. Brody and William A. Isaacson, Rogovin, Huge & Schiller, Washington, D.C., of counsel), *for Defendants-Appellants.*

James A. Moss, Herrick, Feinstein, New York, New York, of counsel, *for Defendant-Appellant Atkins.*

Paul R. Grand and Lawrence S. Bader, Grand & Ostrow, New York, New York, of counsel, *for Defendant-Appellant Hack.*

VAN GRAAFEILAND, *Circuit Judge*:

Charles Agee Atkins and William S. Hack appeal from judgments convicting them of violating and conspiring to violate 26 U.S.C. §§ 7206(1) and (2) and 18 U.S.C. § 371,

following a jury trial before Judges Weinfeld and Lasker in the United States District Court for the Southern District of New York. The charges included the willful making and subscribing of false individual and partnership tax returns, § 7206(1), and aiding and assisting in the filing of false individual and partnership returns, § 7206(2). *See United States v. Atkins*, 661 F. Supp. 491 (S.D.N.Y. 1987). We affirm.

Appellant Atkins was the founder and principal owner of a limited partnership called The Securities Groups, one of whose functions was the creation of tax write-offs for investors in money market instruments, primarily United States government securities. Appellant Hack controlled a similarly occupied company called Mountain Associates. The word "securities" may be somewhat misleading because, in the main, no physical certificates changed hands in the transactions involved herein. As one witness explained it:

> Well, there are no physical certificates. The treasury stopped issuing the physical certificates a number of years ago. And when we refer to deliveries, what we are referring to are book entries done on the Federal Reserve system computers. So that the computer in fact keeps track of where the securities are versus where cash is. So that all of these transfers are actually electronic transfers of treasury bills versus fed funds.

Indeed, as another witness pointed out, artificial transactions in treasury bills or notes could be conducted without first purchasing anything from the treasury:

> But with these so-called artifical [sic] transactions, they didn't require one having to actually go out and

> buy anything from the treasury. A dealer would just put something on his books indicating a purchase of transactions or purchase of some volume of securities as of day one in a sale as of some later day and then have corresponding transactions with some other party that also is self-reversing in that way. And that could be done without any transactions actually having to exist or be delivered over the delivery network in the government securities market. It didn't require that treasury securities actually exist.

At one point The Securities Groups' balance sheet showed it with $24 billion of assets and liabilities, with less than a $100 million of capital.

Although the Groups' offering memoranda represented that the Groups intended to handle clients' investments for the primary purpose of realizing economic gains, its real purpose was to generate tax losses for investors who needed them to offset unrelated gains. Such investors were promised 4 to 1 tax write-offs based on an investment consisting of 25 percent cash and 75 percent notes.

Because there is little dispute as to the facts, we need not recount in detail the evidence produced at trial. The Government proved beyond a reasonable doubt that Atkins, with the conniving assistance of Hack and other unindicted accomplices, created, purchased, and sold millions of dollars in fraudulent tax losses for his companies and his customers. Appellants used two basic schemes in creating the fraudulent losses—rigged straddles and rigged repurchase agreements.

A straddle in the securities industry is the concurrent establishment of "long" and "short" positions in a security or securities. A person is "long" if he has contracted to buy a quantity of securities for future delivery, specu-

lating on an advance in the market; he is "short" if he has contracted to sell securities that he may not yet own, speculating on a decline in the market. Prior to the enactment of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, 323-26, dealers such as appellants, by going long and short at the same time, *i.e.*, "straddling", could close out in one year the leg of the straddle that showed a loss and close out in the succeeding year the other leg showing the gain, thus deferring for one year the tax on the offsetting gain.

However, the ordinary straddle is not risk free because there is no assurance that the gain on the second leg will be equal in amount to the loss on the first leg. One witness described a straddle as the "simultaneous purchase and sale of similar but different instruments such that if the market interest rates moved, one side of the position would be profitable, while the other side would automatically lose money." *See Lasker v. Bear, Stearns & Co.*, 757 F.2d 15, 16-17 (2d Cir. 1985). Because The Securities Groups was engaging in transactions involving billions of dollars, it proposed to eliminate the possibility of what could be extremely large losses resulting from such market fluctuations.

To accomplish this, it found accomplices such as Hack who, for a fee, were willing to enter into "paper" or computer transactions giving the Groups substantial first leg losses and then, by means of additional "paper" transactions, adjusting the second leg so as to eliminate any gains or losses that otherwise might result from market fluctuations. As one witness described the process, "the entire transaction from start to finish would be arranged, we'd know the end result going into it, and the only economic risk would be the fee paid for the loss."

Another witness, describing a deal between the Groups and appellant Hack, testified as follows:

> Q. In this particular transaction between The Securities Groups and Mountain Associates, was there any market risk?
>
> A. No.
>
> Q. And again, could you explain to the jury why that was the case?
>
> A. Because I had told Mr. Hack that we were going to be putting these on for tax purposes, and that there was no intention on our part to either make or lose money, and that as the market moved before year-end, I would realize the losing portion and put the straddle back on, and basically end up the trade when all was said and done with zero profitability.

In general, the process thus briefly described works as follows: After the dealer puts the straddle back on, he enters into a new futures contract, the second leg of which would be the exact opposite of the second leg of the original straddle. In other words, if the second leg of the original straddle called for a long position, the second leg of the new straddle would call for a short one, and vice versa. This would insure that, no matter which way the market moved, the deferred gain on the original straddle would not be affected. *See Sochin v. Commissioner*, 843 F.2d 351, 352-53 (9th Cir.), *cert. denied*, 109 S. Ct. 72 (1988); *Lasker v. Bear, Stearns & Co.*, *supra*, 757 F.2d at 16-17.

There was no expectation of profit in the transactions above described, their sole purpose being the creation of artificial tax losses.

Repurchase agreements ("repos") are devices for financing the purchase or sale of securities. The securities form the collateral for the loan, and the interest on the loan may be either pegged to the interest rate to maturity of the underlying security ("repo to maturity") or permitted to float according to the prevailing market rate at any given time ("open" or "term" repo). In a repo to maturity transaction, there can be no profit or loss in connection with interest charges, since they coincide with the interest payable on the collateral security. In an open or term repo, there can be profit or loss, because the interest charges on the loan can be lower or higher than the interest payable on the collateral. The Groups eliminated the possibility of such profit or loss on transactions carried on its books as open or term repos by secretly using repo to maturity rates. They used the undisclosed repo to maturity agreements to purchase treasury bills maturing in the year following purchase, but redeemed them in December of the purchase year as if the financing was an open or term repo. The interest expense payable under these term or open repos generated the desired tax losses. At the same time, the secret repo to maturity agreements insured that no profit or loss due to market fluctuations would occur. Again, we use the words of one of the Groups' employees to describe how this fraudulent procedure worked:

> Q. Could you describe for the jury what was said during that conversation and who was speaking?
>
> A. Mr. Gubitosi said that he had come up with a plan to generate tax losses without using straddle situations.
>
> Q. Could you describe what was said about that.
>
> A. He described a method by which we were going to be, we being The Securities Groups were going to

go long treasury bill securities and have a financing agreement against it. In fact, the financing agreement would be written on an open basis when in fact it would actually be a repurchase agreement to maturity taking out the risk.

Mr. Gubitosi was very happy that he had come up with this and said, "I don't know why we ever did straddle transactions to begin with, we never had to, we only needed a one side transaction."

Q. Do you recall how he described what you were going to do?

A. He basically said, "Here we have the traditional straddle transaction, we will take the short side, roll it up in a ball and throw it away, we don't need it anymore," meaning by that we could have the long position which would generate the gain the following year and we would have the financing agreements which would generate the loss in the current year.

Q. Would there be any risk in these transactions?

A. No.

Q. Why not?

A. The transactions when they are put on are basically financed to maturity even though the transaction would be listed as an open trade.

Q. Would it still appear as a transaction that had economic risk?

A. Yes.

Appellants used both of above-described devices, or variations of them, to create hundreds of millions of dollars in apparent losses. They also backdated or caused to

be backdated a large number of documents in order to increase the amount of their fraudulent claims. For example, the backdating of a purchase or sale by six months would permit the creation of a half year of phantom interest expense. Appellants also falsified other documents that were needed to carry out their schemes, such as disguising kickback payments as trading losses; and they lied to their lawyers, their accountants, and their customers concerning the true nature of their machinations.

Although appellants do not, indeed cannot, contend seriously that the Government did not prove beyond a reasonable doubt their participation in the above described schemes, they contend that they were deprived of due process because they did not know in advance that their conduct was unlawful. In view of the proven falsification and backdating of documents, the secret oral agreements, the lies and the concealment of facts, this argument borders on the specious. *See United States v. Ingredient Technology Corp.*, 698 F.2d 88, 96 (2d Cir.), *cert. denied*, 462 U.S. 1131 (1983); *United States v. Carruth*, 699 F.2d 1017, 1021 (9th Cir. 1983), *cert. denied*, 464 U.S. 1038 (1984); *United States v. Winograd*, 656 F.2d 279, 282-83 (7th Cir. 1981), *cert. denied*, 455 U.S. 989 (1982); *United States v. Fruehauf Corp.*, 577 F.2d 1038, 1067-68 (6th Cir.), *cert. denied*, 439 U.S. 953 (1978). "A mind intent upon willful evasion is inconsistent with surprised innocence." *United States v. MacKenzie*, 777 F.2d 811, 816 (2d Cir. 1985), *cert. denied*, 476 U.S. 1169 (1986) (quoting *United States v. Ragen*, 314 U.S. 513, 524 (1942)). Moreover, "[t]he doctrine of substance versus form is well ensconced in tax law." *United States v. Crooks*, 804 F.2d 1441, 1449 (9th Cir. 1986), *modified on other grounds*, 826 F.2d 4 (9th Cir. 1987).

Appellants' reliance on 26 U.S.C. § 165(c)(1) (losses allowed if incurred in a trade or business); § 108(a) of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 630 (losses from pre-1982 straddle positions allowed if entered into for profit); and § 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2817-18 (losses from pre-1982 straddles allowed when incurred in trade or business or in transaction entered into for profit), is misplaced. As former Judge Weinfeld correctly held in denying appellants' pretrial motion to dismiss, 661 F. Supp. at 495-96, none of these statutes has been applied to sham transactions such as are involved herein. *See Forseth v. Commissioner*, 845 F.2d 746, 748-49 (7th Cir. 1988); *Enrici v. Commissioner*, 813 F.2d 293, 296 (9th Cir. 1987) (per curiam); *Mahoney v. Commissioner*, 808 F.2d 1219, 1219-20 (6th Cir. 1987); *United States v. Winograd*, *supra*, 656 F.2d at 282-83.

Appellants' contention that transactions without economic substance and sham transactions are "fundamentally distinct legal concepts" and that a sham transaction is a "fictitious transaction that in fact never took place" demonstrates a lack of understanding of what, for tax purposes, a sham transaction is. A fictitious transaction may be treated as a sham; however, so also may a transaction that "has no business purpose or economic effect other than the creation of tax deductions." *DeMartino v. Commissioner*, No. 88-4048, slip op. at 303 (2d Cir. Nov. 23, 1988). "A sham transaction is one having no economic effect other than to create income tax losses." *Neely v. United States*, 775 F.2d 1092, 1094 (9th Cir. 1985); *see also Knetsch v. United States*, 364 U.S. 361, 365 (1960); *Bail Bonds By Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1548 (9th Cir. 1987); *Ballagh v. United States*, 331 F.2d 874, 876-78 (Ct. Cl.), *cert. denied*, 379 U.S. 887

(1964). Appellants' further contention that the district court's charge on lack of substance has no place in a criminal prosecution is without merit. *See United States v. Clardy*, 612 F.2d 1139, 1152-53 (9th Cir. 1980).

Judge Lasker, who completed the trial when Judge Weinfeld became severely ill, charged the jurors that, in order to return verdicts of guilt, they must find that the transactions in question were "without economic substance", *i.e.*, that they had no business purpose apart from the creation of a tax deduction, and that they were subject to no market risk. He stated further that a transaction has no purpose apart from creating a tax deduction if it is not intended "either to make or preserve any profit or to limit a loss in any way" and that it is subject to no market risk "if changes in market prices cannot have any effect" on it. Although Judge Lasker did not use the word "sham", he clearly charged the substance of the term as above defined, and the absence of specific terminology therefore is unimportant. *See United States v. Ingredient Technology Corp.*, *supra*, 698 F.2d at 94; *United States v. Philatelic Leasing, Ltd.*, 794 F.2d 781, 786 (2d Cir. 1986). The charge as given by Judge Lasker is substantially the same as the one we approved in *United States v. Ingredient Technology Corp.*, *supra*, *see* 698 F.2d at 97 n.9. We approve it as given below. Moreover, the proof overwhelmingly supported the jury's verdict.

We have carefully considered appellants' remaining arguments and hold them to be without merit. Accordingly, the judgments of conviction are AFFIRMED.

APPENDIX B

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. SS 87 Cr. 246 (EW)

June 2, 1987

UNITED STATES OF AMERICA,

Plaintiff,

—v.—

CHARLES AGEE ATKINS, WILLIAM S. HACK and ERNEST M. GRUNEBAUM a/k/a "MIKE",

Defendants.

Rudolph W. Giuliani, U.S. Atty., S.D.N.Y., New York City, for the U.S.; Stuart E. Abrams, Jordan Stanzler, Asst. U.S. Attys., of counsel.

Herrick, Feinstein, New York City, for Charles Agee Atkins; James A. Moss, Christopher J. Sullivan, of counsel.

Grand & Ostrow, New York City, for William S. Hack; Paul R. Grand, Lawrence S. Bader, of counsel.

Anderson Russell Kill & Olick, P.C., New York City, for Ernest M. Grunebaum; John H. Doyle, of counsel.

OPINION

EDWARD WEINFELD, District Judge.

Defendants Charles Agee Atkins ("Atkins"), William S. Hack ("Hack") and Ernest M. Grunebaum ("Grunebaum") move pursuant to Fed.R.Crim.P. 12(b)(2) to dismiss the indict-

ment, containing conspiracy and substantive counts, on the ground that no prosecutable offenses are alleged.

Count 1, the conspiracy count, charges that the defendants, as well as persons known and unknown, combined and conspired to defraud the United States of America and the Internal Revenue Service in the ascertainment, assessment and collection of taxes due the Government.[1] Counts 2 through 31 charge the defendants, or combinations of them, with substantive violations in that the defendants wilfully: (1) subscribed to false partnership tax returns, and, in the case of Atkins and Grunebaum, false personal tax returns;[2] and (2) aided or assisted in the preparation of false tax returns of limited partners.[3]

According to the indictment, defendant Atkins was a general partner in four New York limited partnerships that he formed and promoted and in which he acted as a broker-dealer in money market instruments providing significant tax benefits to limited partners. It is further alleged that defendant Hack was an attorney and a tax shelter promoter and that defendant Grunebaum was the head of one of the limited partnerships' divisions and the part owner and officer of a family corporation, which allegedly engaged in fraudulent transactions generating false trading losses and false interest expenses.

The indictment alleges that the goal of the conspiracy was, through pre-arranged, rigged and fraudulent transactions in United States government and agency securities, to create false tax deductions based on fraudulent trading losses and interest expenses that were passed on to the limited partners. The defendants are charged with causing the issuance of fraudulent sales literature that misrepresented the nature of their operation; using secret oral agreements to disguise the true nature of their transactions; creating shell corporations to carry on transactions; paying disguised kickbacks; concealing the true nature of their business from outside auditors; and causing false returns to be filed with the Internal Revenue Service. It is further

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1 18 U.S.C. § 371.

2 26 U.S.C. § 7206(1).

3 26 U.S.C. § 7206(2).

alleged that various transactions were back-dated to generate greater losses, and the "secret oral agreements" were hidden from the limited partnerships' outside auditors.

In broad terms, however variously stated, the essence of the charges is the creation, through fraudulent means, of fictitious trading losses and interest expenses which were passed on to the limited partners who claimed tax deductions in their individual tax returns, thereby impeding the Government in the assessment and collection of hundreds of millions of dollars in taxes properly due from the limited partners. Similar charges are made against the defendants with respect to the partnership, and in the case of Atkins and Grunebaum personal, tax returns.

The Motion to Dismiss the Indictment

In support of their motion to dismiss the indictment, defendants make three arguments: (1) that the transactions mentioned in the indictment were arguably legal when they were performed; thus, it would violate due process for the government to prosecute them under ambiguous laws; (2) that the Tax Reform Act of 1986 grants legislative amnesty for the conduct alleged in the indictment; and (3) that New York's Statute of Frauds would prevent enforcement of secret oral agreements not reflected in the trading confirmations; therefore, they could not have completely eliminated the possibility that the transactions would result in a gain.

Preliminarily, it is noted, as the defendants acknowledge, that the factual allegations of the indictment must be accepted as true.[4] Another principle applicable on this motion, stated in the much cited case *Costello v. United States*,[5] is that an indictment "if valid on its face, is enough to call for a trial of the charges on the merits."[6] While acknowledging that the motion to dismiss the indictment must be decided within the four corners of the document, defendants have submitted an affidavit,

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4 *United States v. Barta*, 635 F.2d 999, 1002 (2d Cir. 1980), *cert. denied*, 450 U.S. 998, 101 S.Ct. 1703, 68 L.Ed.2d 199 (1981).

5 350 U.S. 359, 76 S.Ct. 406, 100 L.Ed. 397 (1956).

6 *Costello v. United States*, 350 U.S. 359, 363, 76 S.Ct. 406, 409, 100 L.Ed. 397 (1956).

sworn to by defendant Atkins, in support of their motion. Reference is made to this affidavit only for the purpose of giving context to their legal arguments; otherwise, the basis of their motion would be incomprehensible.

Atkins states that the events referred to in the indictment concern the tax consequences of TSGS's, one of the four partnerships named in the indictment, trading activities in United States Government and federal agency securities in the cash, futures and forward markets; that all such transactions were recorded on trading tickets and confirmations sent to the counter-parties; that these trading tickets recorded the identity of the parties to the transaction; a description of the securities traded; the quantity and price of the securities; the date of the trade and the financing cost of the transaction. Based on this information, TSGS's independent accountants prepared the firm's tax returns, and conducted seven audits. Atkins further states that he signed the tax returns after accountants assured him that the returns were true and correct. Absent from Atkins's affidavit is any reference to the charge in the indictment that secret unwritten information was hidden from the accountants and was not reflected in any trading ticket.

The defendants assert that the indictment is based primarily upon the government's theory that the applicable law prevents the deductibility of trading losses generated by transactions not entered into for profit.[7] They contend that the government's legal theory is wrong as applied to the partnerships and to their partners and accordingly the indictment should be dismissed.

The defendants portray themselves as procurers of legitimate "tax straddles"—commodities transactions entered into for the sole purpose of realizing a tax loss. The basic legal question, they argue, is whether "loss legs of future straddle transactions could [ ] be closed out and recognized for tax purposes without simultaneously recognizing the unrealized gain from the gain legs."[8] Defendants also contend that it is not illegal to enter into transactions to eliminate the prospect of gain, which is all they maintain the indictment alleges.

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7 Atkins Memorandum of Law at 4.

8 Atkins Memorandum of Law at 29.

Apparently, the commodities tax straddle was a popular tax shelter technique during the years referred to in the indictment. A straddle transaction involves an individual taking two or more positions calling for the purchase of a specified commodity in one or more months and for the sale of the same commodity in one or more different months. Each position is referred to as a "leg" of the straddle. In tax straddles, customarily the loss leg of the straddle is closed out in order to realize a tax loss and a similar position acquired in a different month so that the economic consequences and risks to the holder are minimized. This substitution is referred to as a "switch."[9]

In the commodities market,

> [e]very position held by a person is matched by an exactly opposite position (or series of positions) held by one or more other persons. Thus, a loss realized on a closeout will be matched by the realization of a gain in the same amount, provided the opposite position was acquired at the same time and held to close-out.[10]

As such, it is the nature of the market to generate *some* taxable gain. Even where an investor enters into the commodities market with an eye toward realizing a tax loss, he will eventually have to report a gain on the gain leg of the transaction. There are some situations where the investor runs the risk that the spread between his positions will remain constant, with neither leg of the straddle becoming a loss leg.

None of the foregoing obtains when the commodities transactions are prearranged or bogus, the type of transactions the Government alleges here. In a bogus arrangement, there is absolutely no risk that the desired loss will not be realized. Additionally, there will never exist a taxable gain to correspond to the reported tax loss. As the government states, courts have consistently disallowed the intended tax effects of transactions

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9 *Miller v. Commissioner*, 84 T.C. 827, 828-29 (1985). *See generally Lasker v. Bear, Stearns & Co.*, 757 F.2d 15, 16-17 (2d Cir. 1985); *Commodity Exchange, Inc. v. Commodity Futures Trading Commission*, 543 F.Supp. 1340, 1342 (S.D.N.Y.1982), *aff'd*, 703 F.2d 682 (2d Cir. 1983).

10 *Miller*, 84 T.C. at 830.

"without an economic effect, the only purpose of which was tax avoidance."[11] Against this background, we address defendants' contention that, at the time the transactions mentioned in the indictment were entered into, the law was unclear whether losses derived from those transactions were deductible.

Generally, whether a given loss is tax deductible is governed by Section 165(c) of the Internal Revenue Code of 1954, which provides in part:

> Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—
>
> (1) losses incurred in a trade or business;
>
> (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business.

Defendants concede that the losses generated by their activities are not deductible under § 165(c)(2), because the commodities transactions were not entered into for profit. However, defendants contend that § 165(c)(1), which applies to losses incurred in a trade or business, but contains no explicit requirement that the losses be incurred in a profit-seeking transaction, allows for the deductibility of the tax losses they assert they were in the business of generating. In other words, defendants maintain that, because they made a "business" out of entering into commodities straddles for the purpose of generating tax losses, those losses are deductible. As such, they assert it is inconsistent with due process to prosecute persons for engaging in activities not clearly proscribed at the time they were performed.[12] The government disputes the defendants were involved in a "trade or business" within the meaning of § 165(c)(1), and contends

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11 Government's Memorandum of Law at 5. *See United States v. Ingredient Technology*, 698 F.2d 88, 94-95 (2d Cir.), *cert. denied*, 462 U.S. 1131, 103 S.Ct. 3111, 77 L.Ed.2d 1366 (1983); *United States v. Winograd*, 656 F.2d 279, 282-83 (7th Cir. 1981), *cert. denied sub nom., Siegel v. United States*, 455 U.S. 989, 102 S.Ct. 1612, 71 L.Ed.2d 848 (1982); *Julien v. Commissioner*, 82 T.C. 492 (1984).

12 *See United States v. Harriss*, 347 U.S. 612, 617, 74 S.Ct. 808, 811, 98 L.Ed. 989 (1954); *United States v. L. Cohen Grocery Co.*, 255 U.S. 81, 89, 41 S.Ct. 298, 300, 65 L.Ed. 516 (1921).

that whatever "business" the defendants were involved in as alleged in the indictment was illegitimate.

Prior to the adoption of § 108 of the Tax Reform Act of 1984, which created a rebuttable presumption that commodities straddle transactions were entered into with a reasonable expectation of realizing a profit, and allowed tax deductions for losses incurred in all pre-1982 commodities transactions, an individual taxpayer was required to show that he had a nontax profit motive for his commodities investment.[13] While defendants have the advantage of this presumption, it is rebuttable; the government must be afforded the opportunity to rebut it. Section 108 does not allow tax deductions obtained from fictitious or bogus transactions.[14]

Defendants further argue that their conduct with respect to their partnership tax returns has been exonerated by the enactment of Section 1808(d) of the Tax Reform Act of 1986, which provides that losses from pre-1982 straddles are deductible "if such loss is incurred in a trade or business" without regard to whether the transactions were entered into for profit. That section contains a presumption that "any loss incurred by a commodities trade in the trading of commodities shall be treated as a loss in a trade or business." Again, this presumption is not available where the trades are fictitious or prearranged.[15] Moreover, it is not alleged in the indictment that any of the defendants were commodities traders.

Even accepting the defendants' contention that losses from tax straddle transactions entered into for the express purpose of realizing a loss are deductible under § 165(c), upon the allegations of the indictment, a jury can find that defendants' com-

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13 *See Smith v. Commissioner*, 78 T.C. 350, 390-91 (1982) (existence of nontax profit motive a question of fact on which taxpayer bears burden of proof); *see also Fox v. Commissioner*, 82 T.C. 1001 (1984).

14 *Forseth v. Commissioner*, 85 T.C. 127 (1985), *aff'd sub nom. Enrici v. Commissioner*, 813 F.2d 293 (9th Cir. 1987); *Brown v. Commissioner*, 85 T.C. 968, 1000 (1985); *DeMartino v. Commissioner*, 51 T.C.M. 1278, Dec. 43, 142(M), T.C. Memo 1986-263 (1986).

15 *See Price v. Commissioner*, 88 T.C. No. 47 (April 9, 1987) [Available on WESTLAW, FTX-CS database] (available on LEXIS, FEDTAX library, CASES file); *Glass v. Commissioner*, 87 T.C. 1087 (1986).

modities straddles were sham transactions devoid of the requisite economic substance.[16] Although § 165 allows a deduction for a loss sustained during a tax year that is not compensated by insurance or otherwise where such loss is incurred in a trade, business or in a transaction entered into for profit, the loss must be the result of a bona fide transaction; substance, not form, is the controlling factor.[17]

At no time, under any of the statutes relied upon by the defendants, has there been any question but that sham and fictitious transactions, whether in the form of straddles or other tax loss devices, do not give rise to tax deductions. Here the indictment clearly alleges that the transactions referred to were sham, false, contrived and created by various manufactured acts all for the purpose of defeating the payment of proper income taxes due from the partnership, the defendants and the individual limited partners. If in fact the transactions were carried out for the purposes alleged, the defendants' fine-spun argument suggesting a doubt existed as to the deductibility of the tax straddle losses is without substance.

Defendants' final argument, that New York's Statute of Frauds[18] prevented them from enforcing any secret oral agreement and that their trading activity was therefore legitimate and with economic effect, is specious. Simply because the secret agreements might not have been enforceable in a court of law because of the Statute of Frauds is irrelevant to the question of whether or not those agreements existed and were, in fact, complied with by the parties. Moreover, "it would be high irony to find that the defendants here are immune to prosecution

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16 *See Perlin v. Commissioner*, 86 T.C. 388, 414 (1986); *see also United States v. Turkish*, 458 F.Supp. 874, 887 (S.D.N.Y. 1978); *aff'd*, 623 F.2d 769 (2d Cir. 1980), *cert. denied*, 449 U.S. 1077, 101 S.Ct. 856, 66 L.Ed.2d 800 (1981).

17 *See DeMartino v. Commissioner*, 51 T.C.M. 1278, 1288 Dec. 43, 142(m), T.C. Memo 1986-263 (1986); *see also Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935); *Brown v. Commissioner*, 85 T.C. 968, 998 (1985).

18 N.Y.Gen.Obl.L. § 5-701.

because they never wrote [their agreements] down."[19] It is not and has never been the law that losses generated from bogus transactions, as those alleged in the indictment, are legally deductible. Defendants' motion to dismiss the indictment is denied.

Defendants' Discovery Requests

Defendants request a bill of particulars, as well as identification of the government's expert witness, the conspirators' statements it plans to introduce at trial, statements of witnesses that are exculpatory of the defendants, and any summaries the government will use at trial.

The request for a bill of particulars can be broken three categories: 1) the nature of the "secret oral agreements"—who entered into them, where and when; 2) how the defendants deceived the "outside auditors", who those auditors are and when they were allegedly deceived; and 3) how the trades were "bogus", "fraudulent", "pre-arranged" and "rigged", and whether the government contends that there were no securities underlying the transactions.

The government had already given defendants a marked set of trade tickets representing the trades in which it alleges secret oral agreements are involved. This information is more than adequate to supply defendants with all necessary evidence concerning the alleged secret agreements. Defendants also argue that they need to know the exact date, time, and location of the secret agreements so that each defendant may know whether he was present. As is well known, rarely is a conspiracy established by direct evidence. Usually it is based upon circumstantial evidence of acts and conduct of each conspirator involved. As noted in *United States v. Kahaner*,[20] "if the acts and conduct attributed to one conspirator were in futherance of the claimed conspiracy during its existence, then it is immaterial whether or not other alleged co-conspirators were present or participated therein or had knowledge thereof."

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19 *United States v. Ingredient Technology Corp.*, 698 F.2d 88, 95 (2d Cir.), *cert. denied*, 462 U.S. 1131, 103 S.Ct. 3111, 77 L.Ed.2d 1366 (1983).

20 203 F.Supp. 78, 84 (S.D.N.Y. 1962).

The same rationale holds true as to the requests concerning the auditors. The defendants know the identities of the accounting firms involved, and the indictment outlines the nature of the concealment. The defendants know from the indictment the nature of the deception, and also know when they gave (or failed to give) information to its auditors. A bill of particulars would not assist defendants in learning the nature of the claims against them, but would only serve to allow them to learn of the government's evidence in advance of trial, or to restrict the government's proof upon the trial, improper objectives of a bill of particulars.[21] The defendants also seek to know the government's theory on how the trades were fraudulent, and definition of terms in the indictment. The government has already told defendants that the words in the indictment have their ordinary dictionary meaning. Any further discovery with respect to these terms would encroach on the government's right to preserve for trial the presentation of its evidence.[22]

With respect to the outstanding discovery requests, the government has already stated that it has no plans to call expert witnesses at trial, nor will it use scientific reports. Although the government states that it may call a witness with knowledge of the facts of this case who may also testify as an expert, the government is not certain that it will do so, and therefore cannot at this stage respond to the request. However, if the government does intend to call expert witnesses at trial it shall within a reasonable time before they testify supply in substance the nature of their expert opinions.

The government also represents that it will provide defendants with any exculpatory statements of which it has present knowledge, or learns of in the future. In its memorandum of law, the government states that it will provide exculpatory statements of "any witness." Defendants argue that they are also entitled to the statements of nonwitnesses who may have exculpatory information. Because the rule of *Brady v. Maryland*,[23] prohibits government suppression of *any* evidence favorable to

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21 *See, e.g., United States v. Gottlieb*, 493 F.2d 987, 994 (2d Cir. 1974).

22 *Id.*

23 373 U.S. 83, 83 S.Ct. 1194, 10 L.Ed.2d 215 (1963).

the defense, the government is required to supply the defendants with the information requested. As to statements of coconspirators, the government is not required to provide them because the defendants are on notice of the nature of the conspiratorial agreement.[24] Statements of witnesses or potential witnesses need not be produced to defendants in advance of trial. Such material is governed by 18 U.S.C. § 3500.

Finally, defendants seek any summaries or charts the government plans to use at trial. The government has provided defendants with the exhibits from which the summaries will be made; however, the defendants assert that they are entitled to the summaries themselves so that they may compare the data therein with the data in the exhibits. This is a legitimate request, and such information will avoid delay at the trial; accordingly, the request is granted.

The defendants' requests for a bill or particulars is denied because they already have ample information with which to prepare a defense, and to advance any claim of double jeopardy.[25] The discovery requests are also denied, except that the government is required to furnish all *Brady* material, summaries, and names and expert opinions of all expert witnesses it intends to call at trial. Counsel are requested to appear at the motion term of this Court on June 9, 1987 at 2:15 p.m. to set a trial date.

So ordered.

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24 *See, e.g., United States v. Wilson*, 565 F.Supp. 1416, 1439 (S.D.N.Y. 1983).

25 *See, e.g., Wong Tai v. United States*, 273 U.S. 77, 82, 47 S.Ct. 300, 302, 71 L.Ed. 545 (1927).

APPENDIX C

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket Numbers 88-1116, 88-1123

Filed April 10, 1989

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 10th day of April, one thousand nine hundred and eighty-nine.

UNITED STATES OF AMERICA,

Appellee,

—v.—

CHARLES AGEE ATKINS and WILLIAM S. HACK,

Defendants-Appellants.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by defendants-appellants, Charles Agee Atkins and William S. Hack.

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

/s/ ELAINE B. GOLDSMITH
Elaine B. Goldsmith
Clerk

APPENDIX D

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket Nos. 88-1116, 88-1123

Filed February 23, 1989

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the Twenty-third day of February one thousand nine hundred and eighty-nine.

Present:

HON. ELLSWORTH A. VAN GRAAFEILAND,
HON. AMALYA L. KEARSE,
HON. MILTON POLLACK*
Circuit Judges.

UNITED STATES OF AMERICA,
Appellee,

—v.—

CHARLES AGEE ATKINS and WILLIAM S. HACK,
Defendants-Appellants.

Appeal from the United States District Court
for the Southern District of New York

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

* Honorable Milton Pollack, United States District Judge for the Southern District of New York, sitting by designation.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged and decreed that the Judgment of said District Court be and it hereby is affirmed in accordance with the opinion of this court.

Elaine B. Goldsmith,
Clerk

By: /s/ EDWARD J. GUARDARO
Edward J. Guardaro,
Deputy Clerk

A TRUE COPY
ELAINE B. GOLDSMITH

/s/ ELAINE B. GOLDSMITH
Clerk

Supreme Court, U.S.
FILED
AUG 22 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-2013

In the Supreme Court of the United States

OCTOBER TERM, 1989

CHARLES AGEE ATKINS AND
WILLIAM S. HACK, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether this tax prosecution, which was based on the creation of deductions through transactions lacking economic substance, denied petitioners due process because the tax laws failed to give them fair notice that their conduct was unlawful.

2. Whether a securities transaction lacks economic substance for purposes of the tax laws if the transaction has no business purpose apart from creating a tax deduction and is not subject to market risk.

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In the Supreme Court of the United States

OCTOBER TERM, 1989

No. 88-2013

CHARLES AGEE ATKINS AND
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v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-11a) is reported at 869 F.2d 135. The opinion of the district court denying petitioners' motion to dismiss the indictment (Pet. App. 1b-11b) is reported at 661 F. Supp. 491.

JURISDICTION

The judgment of the court of appeals was entered on February 23, 1989. Pet. App. 1d-2d. A petition for rehearing was denied on April 10, 1989. Pet. App. 1c. The petition for a writ of certiorari was filed on June 8, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Following a jury trial in the United States District Court for the Southern District of New York, petitioners were

convicted of conspiring to defraud the United States by impeding and impairing the IRS in the performance of its functions, in violation of 18 U.S.C. 371, and of willfully aiding and assisting in the filing of false tax returns, in violation of 26 U.S.C. 7206(2). Petitioner Atkins was also convicted of willfully making and subscribing false tax returns, in violation of 26 U.S.C. 7206(1). Petitioner Atkins was sentenced to two years' imprisonment on the conspiracy count and to four years' probation on the remaining counts. Petitioner Hack was sentenced to four months' imprisonment on the conspiracy count and to four years and eight months' probation on the remaining counts. He was also fined $25,000. The court of appeals affirmed.

1. Petitioner Atkins was the founder and principal owner of a limited partnership called The Securities Groups (TSGS), which created fraudulent tax write-offs for investors in money market instruments, primarily United States government securities. Petitioner Hack was a lawyer and acquaintance of Atkins' family. In its offering memoranda, TSGS represented to investors that it intended to handle their funds with a view toward realizing economic gains. Its true purpose, however, was to produce tax losses for investors seeking to offset unrelated income. TSGS promised 4 to 1 tax write-offs based on investments consisting of 25 percent cash and 75 percent notes. Pet. App. 3a-4a; Gov't C.A. Br. 6-8.

TSGS used two types of securities transactions to create fraudulent tax losses: straddles and repurchase agreements. Each type of transaction had no purpose other than to create tax deductions. Each was also rigged to eliminate any possibility of economic profit or loss. Pet. App. 4a.

A straddle in the securities industries is the simultaneous establishment of "long" and "short" positions in a security or securities. A person is "long" if he has contracted to buy

a quantity of securities for future delivery, speculating that the market price of the securities will rise. A person is "short" if he has contracted to sell securities that he may not yet own, speculating on a decline in the market. Prior to the enactment of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 501, 95 Stat. 323-326, a party to a straddle could, at the end of the tax year, close out the "leg" of the straddle that had a loss and claim a tax deduction in that year. During the next year, the party could close out the other "leg" of the straddle, producing a roughly equivalent taxable gain. The effect of a straddle was thus to shift taxable income from one tax year to the next. Pet. App. 4a-5a.

The ordinary straddle, however, is not free from market risk. As a consequence of market fluctuations, there is no assurance that the gain realized on the second "leg" will equal the loss incurred on the first "leg." Because TSGS was engaging in straddles involving billions of dollars, it undertook to eliminate any possibility of potentially catastrophic losses resulting from market fluctuations. Accordingly, TSGS found accomplices, including Hack, who were willing for a fee to enter into "paper" transactions and secret oral agreements that would result in apparent tax losses, but no economic gain or loss. Under the oral agreements, if market prices fluctuated the parties would alter the transaction to eliminate any gain or loss. Pet. App. 5a-6a; Gov't C.A. Br. 7-8.

TSGS's second method of generating fictitious tax losses involved treasury bill repurchase agreements, known as "repos." Repos are devices for financing the purchase or sale of securities, in which the securities serve as the collateral for a loan, and the borrower repays the loan by repurchasing the security. The interest on the loan may be set in two ways: it may be pegged to the interest rate to maturity of the underlying security ("repo to maturity") or

it may float according to the prevailing market rate ("open" or "term" repo). In a repo to maturity transaction, there is no economic risk, and no basis for the borrower to claim an interest expense deduction, since the interest charges coincide precisely with the interest payable on the collateral security. In an open or term repo, however, there is economic risk, because the interest rate on the loan can be higher or lower than the interest earned on the collateral security. Pet. App. 4a, 7a.

TSGS used repos to generate false interest deductions by reflecting repo transactions on its books as open or term repos, while simultaneously making secret oral agreements to treat the transactions as repos fixed to maturity. The open repos supplied the desired interest deductions, but the secret, unrecorded agreements eliminated the chance of market gains or losses. Pet. App. 7a; Gov't C.A. Br. 11.

Using the foregoing devices, or variations on them, petitioners created hundreds of millions of dollars in fictitious losses. They also backdated or caused to be backdated a large number of documents in order to inflate the amounts of those losses. Further, they disguised fees that were paid to accomplices as trading losses. Finally, they lied to their lawyers, their accountants, and their customers about the schemes. Pet. App. 8a-9a.

2. The district court denied petitioners' motion to dismiss the indictment. Pet. App. 1b-11b. In so doing, the court rejected petitioners' contention that the tax laws were so confused and ambiguous at the time of petitioners' transactions that it would be a denial of due process to subject them to a criminal prosecution. After canvassing the law regarding the deductibility of tax straddle losses, the court explained why any flux or uncertainty in the tax law had no application to petitioners (*id.* at 8b):

> At no time, under any of the statutes relied upon by the defendants, has there been any question but that

> sham and fictitious transactions, whether in the form of straddles or other tax loss devices, do not give rise to tax deductions. Here the indictment clearly alleges that the transactions referred to were sham, false, contrived and created by various manufactured acts all for the purpose of defeating the payment of proper income taxes due from the partnership, the defendants and the individual limited partners. If in fact the transactions were carried out for the purposes alleged, the defendants' fine-spun argument suggesting a doubt existed as to the deductibility of the tax straddle losses is without substance.

The jury was instructed that the "heart of the case" was whether TSGS's transactions lacked "economic substance." To guide the jury's deliberations regarding that issue, the court gave the following instructions:

> I instruct you that you must find that the transactions in government securities were without economic substance only if you first conclude beyond a reasonable doubt both of the following propositions:
>
> One, that the transactions had no business purpose, apart from the creating of a tax deduction, and,
>
> Second, that the transactions were subject to no market risk.
>
> With regard to the first one of these propositions, no business purpose, I instruct you that transactions have no business purpose apart from creating a tax deduction if they are not intended either to make or preserve any profit or to limit a loss in any way.
>
> With regard to the second of these matters, that is, market risk, I instruct you that transactions are subject to no market risk if changes in market prices cannot have any effect on the transactions.

Gov't C.A. Br. 62-63 n.* (quoting Tr. 5686-5688). The jury convicted petitioners on all counts in which they were charged.

3. The court of appeals affirmed. Pet. App. 1a-11a. The court rejected petitioners' claim that they were denied due process because they did not know in advance that their conduct was unlawful: "In view of the proven falsification and backdating of documents, the secret oral agreements, the lies and the concealment of facts, this argument borders on the specious." *Id.* at 9a. The court also observed that "[a] mind intent upon willful evasion is inconsistent with surprised innocence." *Ibid.*, quoting *United States* v. *MacKenzie,* 777 F.2d 811, 816 (2d Cir. 1985), cert. denied, 476 U.S. 1169 (1986) (quoting *United States* v. *Ragen,* 314 U.S. 513, 524 (1942)). The court added that "[t]he doctrine of substance versus form is well ensconced in tax law." Pet. App. 9a.

The court also rejected petitioners' reliance on various tax statutes that purportedly legitimized straddle transactions, or, at the least, created confusion about the deductibility of losses from them. See 26 U.S.C. 165(c)(1) (allowing losses incurred in a trade or business); Section 108(a) of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 630 (allowing the deduction of losses from pre-1982 straddles, if entered into for profit); and Section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2817-2818 (allowing the deduction of losses from pre-1982 straddles when incurred in a trade or business or in a transaction entered into for profit). The court explained that none of these statutes has been applied to "sham" transactions, such as those involved in this case. Pet. App. 10a.

Finally, the court rejected petitioners' contention that "transactions without economic substance" were entirely distinct from "sham" transactions, which petitioners as-

serted covered only the category of "fictitious transaction[s] that in fact never took place." The court held that under the tax laws, the category of sham transactions also includes those "that ha[ve] no business purpose or economic effect other than the creation of tax deductions." Applying that definition of the term "sham," the court approved the jury instructions, which required the jury to find that "the transactions in question were 'without economic substance', *i.e.*, that they had no business purpose apart from the creation of a tax deduction, and that they were subject to no market risk." Pet. App. 10a-11a.

ARGUMENT

1. Petitioners first contend (Pet. 5-8) that the court of appeals erroneously endorsed the view that a defendant may not challenge a criminal statute on vagueness grounds if he had a subjective belief that his conduct was unlawful. Petitioners argue that in that respect, the decision below conflicts with decisions of this Court and other courts of appeals that determine the adequacy of the notice given by a statute under an objective standard: whether a reasonable person would understand what conduct is within its reach.

The court of appeals did not adopt the position petitioners attribute to it. In the passage on which petitioners rely, the court simply rejected the specific contention that petitioners "were deprived of due process because they did not know in advance that their conduct was unlawful." Pet. App. 9a. The court answered that contention by pointing to petitioners' clandestine oral agreements, their falsification of records, and their cover-up activities, which amply demonstrated that petitioners did "know in advance" that their conduct was unlawful. Nothing in the court's opinion suggests that an impermissibly vague

statute can be rescued simply because the defendant has a subjective belief that his conduct is unlawful. The court's focus on petitioners' actual knowledge merely reflected the court's conclusion that this is not a case in which an unknowing party has been trapped by an obscure or ambiguous rule of law about which he was justifiably confused.

In *United States* v. *Ingredient Technology Corp.*, 698 F.2d 88, 96 (2d Cir.), cert. denied, 462 U.S. 1131 (1983), which was cited by the court in this case (Pet. App. 9a), the Second Circuit explicitly recognized that an objective test governs the evaluation of whether a criminal statute provides fair notice. Relying on *United States* v. *Harriss*, 347 U.S. 612, 617 (1954), and *Bouie* v. *City of Columbia*, 378 U.S. 347 (1964), the *Ingredient Technology* court said: "a criminal statute must meet the requirements of the Due Process Clause and be sufficiently definite as to 'give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden.' " 698 F.2d at 96.

It is, of course, well settled that the mens rea element of a statute may bear on whether the statute is impermissibly vague. A requirement of willfulness, which is an element of the two offenses at issue in this case, "relieve[s] the statute of the objection that it punishes without warning an offense of which the accused was unaware." *Screws* v. *United States*, 325 U.S. 91, 102 (1945); see also *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337, 342 (1952); *United States* v. *Ragen*, 314 U.S. 513, 524 (1942); *Gorin* v. *United States*, 312 U.S. 19, 26-28 (1941); *Hygrade Provision Co.* v. *Sherman*, 266 U.S. 497, 502-503 (1925). As the Court observed in *Ragen*, referring to then-current tax evasion provisions, "[o]n no construction can the statutory provisions here involved become a trap for those who act in good faith. A mind intent upon willful evasion is inconsistent with surprised innocence." 314 U.S. at 524.

Although petitioners contend (Pet. 14-15) that the statutes under which they were convicted did not define the proscribed conduct with sufficient specificity to support a criminal conviction, Congress cannot be expected to define with particularity every possible kind of sham transaction the criminal mind may devise. That observation applies with particular force to the revenue laws because they embrace the entire universe of the nation's economic life. This Court has noted that "Congress did not define or limit the methods by which a willful attempt to defeat and evade [taxes] might be accomplished and perhaps did not define lest its effort to do so result in some unexpected limitation." *Spies* v. *United States,* 317 U.S. 492, 499 (1943). Cf. *United States* v. *National Dairy Corp.,* 372 U.S. 29, 31-33 (1963); *United States* v. *Petrillo,* 332 U.S. 1, 7 (1947); *Nash* v. *United States,* 229 U.S. 373, 377 (1913) (Holmes, J.).

This is not a case in which the underlying conduct lay close to the line between the unlawful and the lawful, and in which the absence of more precise statutory direction resulted in fundamental unfairness to petitioners.[1] Contrary to petitioners' suggestion (Pet. 8), the rigged, prearranged transactions involved in this case did not present a close question of legal interpretation under the tax laws. It has long been the law that the economic substance of a transaction prevails over its form, and that paper arrangements having no economic purpose but to secure tax bene-

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[1] Petitioners' contention (Pet. 5-6) that this case conflicts with *United States* v. *Kozminski,* 108 S. Ct. 2751 (1988), is incorrect. *Kozminski* holds only that a statute that is entirely vague cannot be remedied by requiring the defendant to harbor some specific intent. That is not the case here. The core concept of tax fraud is objectively well defined. The intent requirement in tax prosecutions serves to protect against the use of the criminal laws to punish a good faith violation of the tax code. *United States* v. *Ragen, supra.*

fits can be attacked as shams. See, *e.g.*, *Knetsch* v. *United States*, 364 U.S. 361 (1960); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945); *Griffiths* v. *Commissioner*, 308 U.S. 355, 357-358 (1939); *Higgins* v. *Smith*, 308 U.S. 473 (1940); *Gregory* v. *Helvering*, 293 U.S. 465, 468-469 (1935).

Petitioners' reliance (Pet. 8) on *Smith* v. *Commissioner*, 78 T.C. 350, 385-394 (1982), to support a claim that the law regarding "economic substance" was unclear when petitioners embarked on their tax-straddle scheme is completely misplaced. *Smith* involved silver straddles, purchased through a broker, that involved some "economic risk." *Id.* at 363, 389-390. Nothing in *Smith* suggests that the petitioners' straddles, which involved secret oral agreements to remove *all* market risk, were even arguably valid. Indeed, Congress later took it for granted that rules permitting the deduction of certain straddle losses would not apply "where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the [commodities] dealer is a member." H.R. Rep. No. 426, 99th Cong., 1st Sess. 911 (1985). Moreover, on its facts, *Smith* gave little comfort to the promoters of tax-motivated straddles. The *Smith* court held that the losses from the straddles before it were *not* deductible because the taxpayers using them had "lacked the requisite economic profit objective" under 26 U.S.C. 165(c)(2). 78 T.C. at 394.[2]

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[2] Because petitioners' tax treatment of the transactions in this case was clearly unlawful, the application of the criminal tax statutes did not constitute prosecution for a transaction of uncertain status, as in *United States* v. *Critzer*, 498 F.2d 1160 (4th Cir. 1974), and *United States* v. *Garber*, 607 F.2d 92 (5th Cir. 1979) (en banc). See *United States* v. *Burton*, 737 F.2d 439, 444 (5th Cir. 1984) (*Garber* applicable only where "the legal duty pointed to is so uncertain as to approach the level of vagueness"); *United States* v. *Heller*, 866 F.2d 1336, 1342

2. Petitioners next contend (Pet. 8-14) that the court of appeals' definition of a transaction that lacks "economic substance" is incorrect and is contrary to the definition employed by other courts of appeals.

a. The court of appeals held that petitioners' securities transactions could be found to be "shams," lacking in economic substance for purposes of the tax laws, if (1) they were not intended to make or preserve a profit or limit a loss, and (2) they were not subject to market risk. The jury was instructed accordingly. Pet. App. 10a-11a. Petitioners insist that the jury should also have been instructed to consider other factors in determining whether the transactions had "economic substance." In particular, petitioners urge that the jury should have been instructed to consider whether there were "economic consequences * * * independent of those generated by the tax deductions," including "credit risks" and "financial limitations" that may have foreclosed "other investment opportunities." Pet. 9, 13.

The jury instructions approved by the court of appeals were fully consistent with long-settled principles governing "sham" transactions. This Court has held that a transaction is a sham when there is "nothing of substance to be realized by [the taxpayer] beyond a tax deduction." *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960). A transaction will not be recognized for tax purposes unless it serves valid and substantial nontax purposes. *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935) (disregarding a "corporate reorganization" that had no business purpose but to channel funds to the taxpayer so as to reduce taxes); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 333-334 (1945) (disregarding a "liquidating dividend" that

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(11th Cir. 1989) (*Garber* and *Critzer* involve "[l]egal uncertainty * * * deriv[ing] from arguably conflicting government pronouncements on narrow issues of law").

was designed solely to enable the reduction of taxes incident to a corporation's sale of property). "The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." *Higgins* v. *Smith,* 308 U.S. 473, 477 (1940) (disallowing a loss deduction realized upon the taxpayer's "sale" of securities to his wholly owned corporation).

Both in this case and in others, the court of appeals has demonstrated its understanding of the concept of a sham transaction. See *DeMartino* v. *Commissioner,* 862 F.2d 400, 406 (2d Cir. 1988) ("A transaction is a sham if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions."); *United States* v. *Philatelic Leasing Ltd.,* 794 F.2d 781, 786 (2d Cir. 1986) ("A transaction is a sham if motivated solely by tax avoidance purposes with no independent legitimate economic or business substance.").

Obviously, the general principles contained in those statements require focusing and channeling as applied to a specific set of facts in order for a jury to deliberate meaningfully about "economic substance." The jury instructions in this case accomplished that objective. The instructions reflected the fact that genuine transactions in securities markets aim at the making of profits or the avoidance of loss, and they are exposed to market risk. Securities transactions lacking those features are properly characterized as lacking economic substance. Accordingly, the instructions here guided the jury's attention to petitioner's profit motive and the existence of market risk in their securities transactions. In so doing, the instructions properly gave concrete content to the idea of a sham as

applied to the securities straddles and repos that were at issue.[3]

None of the other factors identified by petitioners are relevant to the determination whether their securities transactions had economic substance. Petitioners point (Pet. 13) to various business effects that TSGS allegedly experienced from engaging in its prearranged straddles and repos. Those include making and receiving "margin payments," incurring "credit risks," and forfeiting other "investment opportunities." Petitioners contend that these "non-price economic effects" could have lent substance to their transactions if the jury had been instructed to consider them.

Petitioners' views about the type of "economic effects" that are relevant to a transaction's economic substance find no support in the policies of the criminal tax laws. Incidental costs such as those noted by petitioners could not have transformed their riskless, prearranged transactions into ones having economic substance for tax purposes. Virtually any transaction, no matter how much of a "sham," has some of the consequences that petitioners describe. If such inevitable, incidental "effects" could lend economic substance to a transaction, there would be no

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[3] Contrary to petitioners' contention (Pet. 10), the court of appeals did not condemn *all* tax-motivated transactions lacking market risk. The extreme hypotheticals posed by petitioners bear no relation to the facts of this case. For example, the court of appeals has never applied its economic substance analysis to invalidate the activities of tax-free pension funds (which are protected under other policies expressed in the tax laws), a mortgage-interest deduction that makes possible the purchase of a home (and which gives the taxpayer the benefits of ownership), or the sale of stock following a market decline solely in order to deduct the loss (which in any event is governed by statutory "wash-sale" rules to protect against the artificial realization of a loss, see 26 U.S.C. 1091 (1982 & Supp. V 1987)).

limit to the types of frauds that defendants could explain away as having "economic substance." A check kiter, for example, could claim that his circular transfer of funds had "economic substance" because of the payment of transaction fees to a bank. And a nonexistent transaction—one that "happened" only on paper—could be defended as having substance because it had the "economic effect" of foreclosing other investments once it was presented on a company's books. Adoption of petitioners' approach would frustrate the enforcement of the criminal tax laws against nearly all sham transactions.

Petitioners assert (Pet. 11) that *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 583-584 (1978), and *United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725, 736-739 (1977), require consideration of a range of factors not contained in the jury instructions here. Neither case, however, purports to give a laundry list of factors that *must* be considered in measuring economic substance. Rather, in each case, the Court carefully focused on the specific considerations that were relevant to the particular transactions before it. See *Frank Lyon*, 435 U.S. at 576-580 (considering whether a sale-and-leaseback transaction was in reality a financing arrangement; in that setting it was relevant that the lessor assumed credit risks and disclosed a liability on its balance sheet); *Consumer Life*, 430 U.S. at 737 (considering whether a reinsurance transaction was a sham; in that setting it was relevant that the parties negotiated at arm's length and created genuine obligations). Just as the Court in those cases selected relevant factors for discussion, the court of appeals in this securities-related tax fraud case targeted market risk and a profit expectation as the relevant factors for consideration. That approach is entirely consistent with *Frank Lyon* and *Consumer Life*.

At bottom, petitioners' argument simply reduces to the proposition that the costs of perpetrating a tax fraud can legitimize the fraud. Petitioners never explain why this should be so, and such a proposition is plainly unacceptable from the vantage point of sound administration of the revenue laws. In this case, the jury's determination that petitioners' transactions were arranged without market risk or the expectation of profit left only one plausible function to be ascribed to them: the generation of fictitious tax losses.

b. Petitioners contend (Pet. 9) that the decision of the court of appeals conflicts with decisions of the Sixth, Seventh, and Ninth Circuits, in *Rose* v. *Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494, 500 (7th Cir. 1988); and *Collins* v. *Commissioner*, 857 F.2d 1383, 1385 (9th Cir. 1988). Those decisions, they argue, hold that "a transaction lacks economic substance only if it has no 'economic effect' other than those generated by the tax loss" (Pet. 9). That test, they contend, is broad enough to embrace the collateral economic consequences of the straddle and repo transactions that petitioners claim can be found here. See Pet. 11-13.

The decisions on which petitioners rely do not hold that a securities transaction has economic substance for tax purposes even if the transaction lacks a profit motive and market risk. Those cases simply use different verbal formulations to state that a "sham" transaction is one that produces no economic expectation of profit and bears no risk of loss for the taxpayer, but is arranged solely to yield a harvest of tax deductions.[4] A brief examination of the

[4] The court of appeals in this case recited and applied a formula that is virtually indistinguishable from those quoted by petitioner from other circuits: "A sham transaction is one having no economic

facts of *Rose, Yosha,* and *Collins* confirms that there is no conflict between those cases and this one.

In *Rose,* the court upheld the determination that a particular tax shelter—the purchase, based on inflated appraisals, of photo screen negatives for the production of fine arts posters—was a sham because "the taxpayers had no honest profit motive and * * * obtained [no] information on the commercial viability of the packages." 868 F.2d at 854. The court did not pause to consider whether the disclosure of the venture on the taxpayers' financial statements may have foreclosed other investment opportunities, or whether some incidental fees paid to accountants or others gave the transaction substance.

Likewise, in *Yosha,* the court considered a complex commodities straddle, which, like petitioners', boiled down to the risk-free sale of tax losses with no expectation of profit. The court explained that the transactions were shams because "[s]traddles that involve no market risks are not economically substantial straddles and hedges; they are artifices created by accomplices in tax evasion, the brokers." The court added that "[t]he lack of substance lies in the fact that the investor had zero prospect of gain or loss. The brokers were selling tax losses." 861 F.2d at 500-501. These are the same factors relied on by the court here. *Yosha* plainly did not embrace a rule that would confer economic substance on contrived transactions merely by pointing to some incidental economic effects.

Finally, in *Collins* the court agreed with the Tax Court that a mining tax shelter lacked economic substance. Although the court declined to apply the Tax Court's "generic tax shelter" analysis, it held that an examination

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effect other than to create income tax losses." Pet. App. 10a (quoting *Neely* v. *United States,* 775 F.2d 1092, 1094 (9th Cir. 1985)). Cf. Pet. 9.

of the "taxpayers' profit motive and the venture's economic substance" (857 F.2d at 1385) led to the conclusion that the shelter at issue in that case did not have a sufficient economic purpose to justify the creation of legitimate tax deductions.

Thus, rather than revealing any split among the circuits, *Rose, Yosha,* and *Collins* confirm that there is substantial agreement on the application of the "economic substance" doctrine. See also *Ratliff* v. *Commissioner,* 865 F.2d 97, 99 (6th Cir. 1989) (adopting *Yosha*); *Keane* v. *Commissioner,* 865 F.2d 1088, 1091-1092 (9th Cir. 1989) (straddle transactions that were not designed to produce real economic gains lacked economic substance); *Friedman* v. *Commissioner,* 869 F.2d 785, 792 (4th Cir. 1989) (same).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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